April 15, 2013

The Honorable Vern Buchanan
United States House of Representatives
2104 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Allyson Schwartz
United States House of Representatives
1227 Longworth House Office
Washington, D.C. 20515

Dear Congressman Buchanan and Congresswoman Schwartz:

The United States Congress has not had a better opportunity to reform the country's complicated and burdensome tax code in almost 30 years. With continued economic uncertainty and a remaining focus on the nation's fiscal position, many privately held and family-owned businesses are looking to policymakers to limit the uncertainties created by the country's antiquated patchwork of tax policies and the fragmented process by which they are created. Private companies want to work alongside lawmakers to simplify the tax code in order to create more certainty for American employers, boost competitiveness, and contribute to a robust economy.

- *Forbes Magazine estimated that the 223 largest private companies in the United States employ 4.4 million people and account for $1.3 trillion in revenues.*[1]
- *According to a study by Drs. Robert Carroll and Gerald Prante of Ernst and Young, flow-through businesses accounted for nearly 95 percent of all business entities, reported 36 percent of all business receipts, reported 54 percent of all business net income, and paid 44 percent of all federal business income taxes.*[2]
- *Private company CFOs, according to a joint study by Financial Executives International and Baruch College of New York, overwhelming pointed to the individual tax rates as the key legislative proposal that senior financial executives hope Congress will continue to focus on in the current Congress.*[3]

[1] DeCarlo, Scott, Andrea D. Murphy and John J. Ray, *America's Largest Private Companies*, Forbes Magazine, Nov. 3, 2010.
[2] Carroll, Dr. Robert and Gerald Prante, *The Flow-Through Business Sector and Tax Reform*, Ernst & Young, April 2011.
[3] Financial Executives International and Baruch College of New York, *4th Quarter 2012 CFO Outlook Survey*. 2012.

Members of the Private Companies for Tax Fairness (PCTF) coalition are extremely thankful to both the Committee on Ways and Means in the House of Representatives and the Committee on Finance in the Senate for the countless hearings, discussion drafts, white papers, and meetings aimed at reforming the nation's tax code.

Privately held and family-owned businesses represent a significant amount of business-sourced income in the United States. Virtually all pass-through entities are privately-held and/or family-owned businesses, whereas virtually all public companies are organized as C-corporations. Pass-through tax structure has been the preferred form of organization since 1986, when the tax code created a dual level of taxation on corporate-sourced income distributed to shareholders. Business-sourced income for both pass-through entities and C-corporations are taxed. The marginal tax rate on pass-throughs is currently based on the individual rate schedule – 39.6% effective January 2013 whereas the corporate rate is 35%.

<u>Key areas of concern for privately held and family-owned businesses include:</u>

1. Marginal Income Tax Rates, Effective Income Tax Rates and Complexity –

   As a matter of principal and economic fact, a viable income tax code would result in the largest number of businesses paying the same effective income tax rate on its business sourced income. In doing so, the code would be simple to understand, transparent and have a minimal cost in which to comply. Unfortunately, our existing code fails on all fronts. For tax reform to be effective, we believe it needs to address all of these issues. As it relates to privately held companies, these issues have become even more acute as marginal rates have increased. The code and cost to comply with it continues to escalate and there is a potential that reform might only be extended to certain businesses, many of them publically held, C-corporations.

   A: Marginal rates on privately held, pass- through entities need to be lowered to provide sufficient capital to sustain and grow the businesses and the capital, human and otherwise (capital investment, operational expenses/working capital or R&D), that the businesses fund. For privately held, pass-through companies, growth is primarily funded through the reinvestment of the after tax operating cash flow of the business. Higher individual income tax rates enacted in 2013 and as part of the Patient Protection and Affordable Care Act are reducing these company's after tax cash flows. These companies do not have the ability to compensate for the higher taxes by increasing prices; therefore, the tax increase constrains growth. Privately held and family-owned businesses are already intensely focused on improving operating efficiency in this low market growth environment, while at the same time rewarding employees for their contributions. Reducing after tax cash flow (due to higher tax rates) severely constrains a privately held company's ability to continue to invest and create new jobs in the future.

   B: There should be fairness and consistency in the taxation of business sourced income regardless of the form of entity.

A member of the PCTF coalition states, **"The fundamental issue for our company is that the recent increases in the top federal individual tax rate and the 3.8% tax on passive income that was part of the PPACA, have put my company at a significant competitive disadvantage versus our competitors, who are all large public companies. Our combined federal and state tax rate (including the PPACA tax) is now approximately 12 percentage points above our competitors."**

As noted above, the impact of the 2013 legislation has already impaired the competitiveness of privately held, pass-through entities relative to companies formed as C-corporations, whose rates were unaffected.

There is agreement that the current US corporate tax rate environment is not competitive internationally and that there should be a lower marginal rate. There is consensus building to lower marginal rates on corporate income offset by eliminating or reducing tax expenditures. However, lowering only the corporate rate but applying limitations on business deductions on all companies without addressing those privately held, pass-through businesses will:

- Fall short of the desired goal to make US based businesses competitive internationally.
- Discriminate against privately held businesses by materially lowering the economic value of their businesses, measured by after tax returns, when compared to similar businesses organized in a corporate structure.
- Not attract foreign based investors to form businesses in the US.

Consequently, an essential goal of tax reform should be to treat all business-sourced income consistently, regardless of whether generated from a C corporation or pass-through entity.

2. Estate Tax Relief –

While members of the PCTF coalition are appreciative of the work that was done during the 112th Congress to protect privately held and family-owned businesses from a higher estate tax, members of this coalition are still unduly burdened by this tax. For many family-owned businesses, in order to keep operating after the death of the owner, they must plan for the estate tax. This is not only a drain on business resources, but takes money away from the daily operations as well as from business investment. These additional costs make it more difficult for the business owner to expand and create new jobs.

A member of the PCTF coalition states, **"In our case, we spend well over a $1,000,000 each year on insurance policies that help mitigate the tax liability from an emergency standpoint. In addition, we spend more money every year for other strategies and vehicles to try to work around the estate tax issue. At the same time, over 15% of our existing work force is temporary. I think it would be safe to say we would be much more willing to put on full time employees, with the additional cost**

for benefits and pay, if we did not have to spend so much every year just trying to keep in the family what is already theirs."

Therefore, we encourage Congress to continue to work towards lowering this onerous tax until the opportunity arises for its full repeal.

3. Alternative Minimum Tax –

   Certain features of the AMT regime penalize private companies who have "international operations" and/or "perform R&D and have experienced a transition of ownership such that some owners are not active in the business."

   A member of the PCTF coalition states, **"Our business is impacted by both of these factors; due to the non-active owners (i.e., heirs of the original shareholders who have chosen not to be active employees of the business), our R&D expense is amortized over 10 years for AMT purposes, whereas it is expensed in the year incurred for regular tax purposes. This triggers an AMT tax and offsets an incentive in our tax policy to encourage U.S. based R&D. It also encourages transferring R&D to jurisdictions that do not have this perverse rule. It is a carryover from the tax-shelter days but is negatively impacting companies in the United States. For AMT purposes, the R&D credit and the Foreign Tax Credit are also limited, thus increasing the likelihood of our business earnings being subject to AMT."**

4. Earnings of Foreign Operations (i.e., tax deferral)

   S corporations are only allowed to claim a foreign tax credit for foreign taxes <u>directly</u> paid; therefore, unless the foreign operations of the U.S. based parent are structured as a "pass-through" such that the foreign tax obligation is considered to be directly paid, the S corporation experiences two levels of tax similar to a C corporation in the U.S. (i.e., foreign country tax when earned and U.S. tax upon repatriation of the earnings)

   A member of the PCTF coalition states, **"Some of our foreign operations need to be structured as C corporations. As such, double taxation becomes an issue. The territorial tax proposal has potential to minimize/mitigate this, however, as currently proposed, only applies to U.S. C-corporations. With the current structure, we reinvest foreign corporate earning offshore as a policy to avoid the double taxation. For our business, which is growing faster outside the U.S., the reinvestment is in active business assets (i.e., non-cash). The important point is that the current U.S. tax policy is a deterrent to reinvesting in this country. Assuming that we go down the territorial taxation path when tax reform is implemented, it needs to accommodate both C-corporation and "active" pass-through structures.**

Congress has a golden opportunity to reform the tax code in order to make it less complex, eliminate much of the uncertainty, and assure that taxation remains fair for all businesses, regardless of size, industry and structure. Private companies should be recognized for their continued contributions to economic growth and jobs and not unfairly penalized.

Members of the Private Companies for Tax Fairness (PCTF) coalition welcome any opportunity to provide additional information on creating an environment with more certainty, providing competitive tax rates for all businesses, and preserving the ability of companies to structure in a way that matches their unique needs.

About FEI:

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